**City of Detroit**
CITY COUNCIL

IRVIN CORLEY, JR.
DIRECTOR
(313) 224-1076

FISCAL ANALYSIS DIVISION
Coleman A. Young Municipal Center
2 Woodward Avenue, Suite 218
Detroit, Michigan 48226
FAX: (313) 224-2783
E-Mail: irvin@cncl.ci.detroit.mi.us

ANNE MARIE LANGAN
DEPUTY DIRECTOR
(313) 224-1078

TO: COUNCIL MEMBERS

FROM: Irvin Corley, Jr., Director ICJ

DATE: November 20, 2009

RE: Resolution Authorizing to Submit an Application to State Administrative Board for Approval to Issue Fiscal Stabilization Bonds Not to Exceed $250,000,000 **(Recommend Approval)**

Resolution Authorizing to File a Deficit Elimination Plan with the Michigan Department of Treasury **(Recommend Approval)**

## Introduction

Before your Honorable Body is a resolution authorizing the submission of an application to the State Administrative Board for approval to issue up to $250 million in fiscal stabilization bonds.

If Council approves this resolution, then it is submitted to the State Administrative Board along with a deficit elimination plan. Therefore, a resolution authorizing the City to file a deficit elimination plan with the State Treasury Department is also before your Honorable Body for consideration. The State Administrative Board reviews the application and deficit elimination plan to determine the need for the City of Detroit to issue fiscal stabilization bonds to help address its known and estimated operating deficit.

If the State Administrative Board approves the application based on the deficit elimination plan, then the City would have the authority to issue fiscal stabilization bonds under the Fiscal Stabilization Act, Public Act 80 of 1981.

At that point, the City's Finance Department would come back before your Honorable Body with a resolution authorizing the actual sale of the fiscal stabilization bonds. Because of the lengthy process of seeking Council and State Administrative Board approval and marketing the bonds in the secondary bond market, it could take up to 3 months, or by February 2010, to sell the $250 million in fiscal stabilization bonds in order to help the City address its accumulated operating deficit and meet its cash needs.

Council should note that the Fiscal Analysis Division received the aforementioned resolutions with some details this past Wednesday, which gave us only a few days to review and analyze to the best of our ability the resolutions and deficit elimination plan. Given the magnitude of the City's accumulated deficit, which is estimated by the Finance Department at $326 million as of June 30, 2009, and the complexity of the issue, along with the deficit elimination plan documentation, we in Fiscal Analysis could not analyze these documents with the level of thoroughness we normally prefer. Under normal circumstances, it would have been more ideal for Council, its staff and divisional staff, to receive these documents at least two weeks in advance.

**Consideration for Approval on Friday, November 20, 2009**

Even though it is stressful for the Council and its staff to review these complex documents over a few days, the Administration would like for your Honorable Body to consider approving the resolutions described previously today mainly for the following reasons:

1. The City could run out of cash by January 2010. The partial cash flow statement shared with your Honorable Body a month ago showed the City running out of cash this month. We are not certain how the City remains afloat cash wise at this point. However, we understand that the City may still need to sell up to $45 million in Tax Anticipation Notes (TANs), which of course are short-term borrowing instruments, shortly in order to generate enough cash to meet payroll and pay bills over the next month. Council gave the Finance Department the authority to sell up to $94 million in TANs a month ago.

2. We understand that the City's constant cycle of using short-term borrowing instruments such as TANs and Revenue Anticipation Notes (RANs) to meet cash flow needs while the City continues to suffer chronic and growing operating deficits has virtually discouraged investors to purchase these short-term notes from the City. Apparently, investors now deem short-term instruments associated with the City of Detroit as high risk instruments, which makes them harder and more expensive for the City to market. In fact, we understand there is a very limited pool of investors even interested in purchasing the $45 million TANs instrument over the next month to help the City meet immediate cash flow needs, which is troubling.

3. The magnitude of the City's accumulated deficit estimated at $326 million at June 30, 2009 is huge. Investors and rating agencies know the City will not cure this deficit over a year or two. So apparently, investors now deem longer-term fiscal stabilization bonds as a less risky way to address the City's deficit, as long as there is an identifiable source of revenue that can be pledged to pay off the bonds, and there is a viable plan in place to address the deficit. However, as stated previously, it could take up to February 2010 to sell any fiscal stabilization bonds; so the Administration would like for your Honorable to consider approving the resolutions today to start the process rolling.

## The Resolution for the Fiscal Stabilization Bond Application

Again, the Administration requests authorization to submit an application to the State Administrative Board for approval to issue fiscal stabilization bonds not to exceed $250 million. It is the Administration's intent to use the $250 million to fund the City's accumulated deficit of $220 million as of June 30, 2008, set up a debt service reserve account, and pay bond issuance cost. The Administration currently estimates that the City would pay interest on these bonds based on an interest rate of around 6%. The bonds would amortize over a 20-year period.

### *Issuance Under Current Legislation*

However, under the current Fiscal Stabilization Act, PA 80 of 1981, the City can only issue up to $125 million in fiscal stabilization bonds to raise new money to partially address the City's accumulated deficit as of June 30, 2008. The legislation says that the maximum cap for new money fiscal stabilization bonds is the lesser of $125 million or 3% of the State Equalization Value (SEV). Please refer to a report prepared by the Research and Analysis Division dated November 19, 2009 that supports this interpretation.

Under this scenario, the Administration has indicated that it would issue the $125 million in new money fiscal stabilization bonds and refinance existing short- term debt to the tune of at least $95 million in order to free up enough cash to fully address the deficit as of June 30, 2008. Miller Canfield, bond counsel for the City, opines that the current Fiscal Stabilization Act enables the City to refinance any outstanding existing debt. A copy of their opinion has been submitted to Council.

### *Issuance Under Amended legislation*

It is important to note, however, that the Administration is currently pushing legislation at the State level to amend the current Fiscal Stabilization Act in order to set the maximum cap at the 3% of SEV only for the issuance of new money fiscal stabilization bonds. According to the Administration, the City would be able to issue up to approximately $375 million in new money fiscal stabilization bonds if the State act is amended to reflect this new cap. Under this scenario, the Administration could sell up to $250 million in new money fiscal stabilization bonds to entirely fund the deficit at June 30, 2008, set up a reserve account and pay for bond issuance costs.

Council should also note that the Administration is seeking to amend the current Fiscal Stabilization Act to pledge as a first lien state revenue sharing as the source of revenue to meet debt service (principal and interest) payments on any fiscal stabilization bonds. As a result, the pledged state revenue sharing would go to a trustee, thus assuring that these dollars are set-aside for this purpose. This would give bond investors greater assurance that these bonds would be paid off, even if the City were to ever go into bankruptcy.

According to the Administration, the State legislature has favorably accepted these amendments to the Fiscal Stabilization Act, and such amendments could occur before January 1, 2010. This appears optimistic. At any rate, even though it would be ideal if the legislation could be amended before any fiscal stabilization bond sale, thereby giving the City more flexibility in raising enough new money bonds to address the deficit, and give bond investors more assurance concerning repayment, it is not critical at this juncture that amendments be in place by January 1st since the Administration has to come back to your Honorable Body for the actual fiscal stabilization bond anyway, and it is a good possibility that the State law is amended by that time. And, under the worse case scenario, the Administration would still be able to sell the fiscal stabilization bonds under the current legislation to significantly address the accumulated deficit at June 30, 2008.

*Amortization Period Under Current Legislation*

In 2003, the City of Detroit issued up to $69 million in fiscal stabilization bonds, and chose to repay those bonds over five years.

The Administration intends on marketing the $250 million in fiscal stabilization bonds as 20-year bonds. Miller Canfield has opined that the City could repay these bonds over a 30-year period.

We understand that the both City of Pontiac and the Detroit Public Schools have issued fiscal stabilization bonds that amortize over a period greater than five years.

*The Likelihood of Credit Rating Downgrade*

The current Administration feels it is unlikely that the issuance of up to $250 million in fiscal stabilization bonds itself would be the cause a downgrade in our credit rating, thereby causing an interest rate swap termination event associated with the Pension Obligation Certificates.

A few years ago, the former Administration felt that the issuance of fiscal stabilization bonds, albeit at a much smaller amount ($75 million), would cause a rating downgrade and possibly trigger an interest rate swap termination event associated with the Pension Obligations Certificates.

*Other Municipalities Using Fiscal Stabilization Type Bonds to Fund a Huge Deficit*

We understand that New York City fiscal stabilization type bonds in the late 70's to address its deficit to stave off bankruptcy. In a more recent case, the State of California issued budget stabilization bonds to address a huge deficit.

*Suggested Change to the Resolution submitting Application to the State Administrative Board*

Based on a suggestion by the Fiscal Analysis Division, Section 1. of the resolution referenced above now contains language that Council's determination of the accumulated operating deficit of $326 million as of June 30, 2009 is based on estimates provided by the Finance Department.

**Deficit Elimination Plan**

Again, the Administration requests authorization to submit a deficit elimination plan to the State Treasury Department. A four-year forecast is also submitted. The State Administrative Board has to consider a deficit elimination plan as a basis of its approval or disapproval of the issuance of fiscal stabilization bonds for the purpose of addressing an operating deficit.

In summary, the deficit elimination plan reflects the following:

1. The accumulated deficit at June 30, 2008 is $220 million. We understand that the City's Comprehensive Annual Financial Report (CAFR) as of June 30, 2008 will reflect a general fund accumulated deficit at this amount. However, we also understand that this CAFR will be finalized by noon today. It would be ideal for Council to receive or know about the final CAFR reflecting this accumulated deficit amount before you take action on the resolutions that are before you to ensure the accumulated deficit at June 30, 2008 is in fact around $220 million.

2. The City would issue $230 million in fiscal stabilization bonds to cover the accumulated deficit of $220 million at June 30, 2008.

3. The Administration estimates the operating deficit for 2008-09 at $106 million. Based on Fiscal's report of the accumulated deficits dated October 9, 2009, we feel this estimate is reasonable.

4. The Administration reflects an additional decline of around $70 million in major revenues (state revenue sharing, income tax, casino wagering tax and property tax) for the current fiscal year 2009-10, which we deem reasonable based on current trends.

5. The Administration addresses the 2008-09 operating deficit and revenue short falls in 2009-10 by some $7.3 million in layoffs; $11 million savings from Cobo deal; $3 million from delinquent receivables collections; $20 million from DTE escrow account associated with the Greater Detroit Resource Recovery Authority (GDRRA); $7 million from the furlough days; $8 million from the Greektown casino settlement; $15 million from Crisis Turnaround Team recommendations: $10 million or the Office Restructuring efforts; $23 million in state revenue sharing cash

posting; $13 million DDOT grant funding; and $13 million from operating surplus in 2009-10, leaving a $47 million accumulated deficit at June 30, 2010 after the implementation of the above initiatives.

6. Year 2010-11 ends up with a $8 million accumulated deficit after initiatives are implemented and reflection of $20 million debt service on the new fiscal stabilization bonds are considered.

7. And, year 2011-12 ends up with a $2 million accumulated surplus after initiatives are implemented and reflection of $20 million debt service are considered.

Based on our preliminary review of the deficit elimination plan, we feel that

- The Administration has made some significant strides to address the City's operating deficit, especially in the current fiscal year 2009-10. However, $43 million of the initiatives to address the operating deficit represent one-time only savings (GDRRA/DTE escrow, delinquent receivables collections and Greektown casino settlement). This means that revenues generated from the one-time measures will not be available for the most part in the next year's budget, and the hole would have to be addressed during the 2010-11 budget process.

- Other cost cutting measures would have to be identified if the savings from the Crisis Turnaround Team and Office of Restructuring initiatives do not materialize.

- We feel that major revenues will continue to decline by another $43 million, based on our estimates and trends. Technically, the expenditures during 2010-11 would need to be reduced by the $43 million if the major revenues decline as we anticipate and another revenue source is not identified to replenish the declined revenues.

- In addition, the Administration assumes a $40 million tunnel deal materializing in 2010-11. This is another one-time initiative that would not reoccur in 2011-12; thereby, putting pressure on the budget process to address this hole.

- Given the difficulty of finding alternative solutions to address the holes created by the one-time initiatives and any additional major revenue decline, we do not see how the City's operational deficit in the next three years can be significantly addressed without the elimination of services and at least 1,000 layoffs.

**<u>Recommendation</u>**

Based on our above preliminary analysis, we recommend that your Honorable Body highly consider approving the resolution authorizing the submission of the application to issue up to $250 million in fiscal stabilization bonds to the State Administrative Board. Although, it would have been better to consider this resolution after an amended Fiscal Stabilization Act the Administration is currently pushing in Lansing, the current legislation still provides the City of Detroit a mechanism to significantly fund the accumulated deficit of $220 million as of June 30, 2008, and pay if off over a longer period of time while giving the City a few more years to make the necessary changes in operations to eventually eliminate future operational deficits.

We agree with the Administration that a constant usage of short-term borrowing to address the City's cash flow needs without significantly reducing operational deficits is basically an unacceptable practice by investors at the present time.

On one hand, paying off the accumulated deficit using long term fiscal stabilization bonds over 20 years allows the City make a lower payment over the 20 year period. But on the other hand, the City will be obligated to make that payment every year over the 20 years, and pay higher interest cost in the end, unless a way can be found to pay off the bonds quicker. It then becomes extremely important for the City to control cost and adjust expenditures with revenues, or it becomes inevitable that the City runs out of cash, and face receivership.

This is similar to refinancing one's home mortgage to take out cash to pay off credit cards and other short-term obligations. The homeowner has cash relief, but is now paying off the short-term obligations over a longer period, and simply cannot afford to open up new short-term debt.

We also sense a real commitment from the Bing Administration to work with your Honorable Body to make the necessary changes this great City needs to avoid it going into receivership. And to be fair, the Administration inherited a huge budget deficit. But we must caution you that serious decisions have to made to "right the ship" financially if one-time measures and restructuring efforts do not materialize at the level anticipated in the proposed deficit elimination plan.

That is why we recommend approval of the resolution authorizing the submission of the deficit elimination plan to State Treasury Department, but we have reservations. First, it appears that the City is going to have to reduce its workforce by a thousand positions in order for it to truly bring the budget in balance operationally. The current deficit elimination plan does not reflect this. Second, at the present time, alternative measures just seem so hard to get done, like regionalizing DDOT, or reducing non-performing bus routes; or, consolidating the City's health department with the County's; or finding new revenues at the level where it makes a big impact on the budget (like raising income taxes to help pay off the fiscal stabilization bonds quicker, or raising the garbage fee again to truly cover the cost of collecting and disposing of refuse); and so on.

We truly believe the City of Detroit can turn around again. But at times, it is going to be with pain.

cc: Council Divisions
Auditor General's Office

Norman White, Group Executive/Chief Financial Officer
Pamela Scales, Budget Director
Donita Crumpler, Manager II-Finance
Charles Beckham, Chief Administrative Assistant
Kamau Marable, Mayor's Office